

TRENDS *IN* INVESTING

Post-Crash Investing Practices Maintain Favor in Rebound

by Carly Schulaka

The more things change, the more they stay the same. FPA's fourth annual *Trends in Investing* study proves this adage. The 2011 study of 407 financial advisers¹ fielded in February gauged the investment vehicles used by advisers. The latest findings confirm that advisers are maintaining their post-2008 market crash investing philosophy of seeking not just the best returns but the best risk-adjusted returns with a continued emphasis on stability, diversification, and alternatives to long-only strategies.

When we first conducted this study of FPA members in early 2008, many individual investors and advisers had a love affair with equities. FPA's 2008 study showed an overwhelming majority (69 percent) of advisers used individual stocks in client portfolios, while only 52 percent used cash and equivalents, and less than one-quarter (23 percent) used what many consider "safe" investments—fixed annuities.

Twelve months and one unprecedented market crash later, the 2009 study revealed some interesting, albeit not unexpected, shifts. Individual stocks lost some standing, with just 46 percent of advisers using them, while cash and equivalents realized a substantial jump to 85 percent. The use of fixed annuities increased to 45 percent in 2009, then climbed slightly in 2010 (49 percent) before slipping slightly in 2011 (39 percent).

Over the last four years, a few investment vehicles have consistently grown in adviser usage, including exchange-traded funds (ETFs), alternative investments, and REITs. Permanent life insurance products have also seen an uptick in usage since 2008. Meanwhile, investment vehicles including mutual funds, individual bonds, variable annuities, and separately managed accounts have maintained fairly consistent usage from 2008 through 2011, showing the smallest standard deviation over time (see Figure 1).

ETFs Are Still Hot

One of the investment vehicles included in FPA's *Trends in Investing* studies demonstrating a significant increase of usage among advisers over the last four years is ETFs. In 2008, 44 percent of respondents reported using or recommending ETFs. That percentage jumped dramatically in 2009 to 72 percent, where it remained in 2010, followed by a slight uptick to 77 percent of advisers using them in 2011.

The clear increase in the number of advisers using ETFs in client portfolios from 2008 through 2011 is to be expected. ETFs first came on the market in the United States in 1993, and for several years they were primarily used by institutional investors. But as the sheer number of ETFs has grown steadily—from 80 in 2000 to 956 in 2011, according to the Investment Company Institute—they've gotten the attention of advisers and consumers, particularly those looking for exposure to asset classes they may not be privy to otherwise.

An industry-wide shift from commission-based to more fee-based business models may also account for the increased usage of ETFs. If an adviser is no longer earning a commission for selling a particular investment, he or she may be more likely to rely on ETFs for diversification and tax advantages not found elsewhere.

Continue the Learning: FPA Experience 2011, September 15–18

Several education sessions at FPA Experience 2011, the annual gathering of the financial planning profession, will address investing topics including bond strategies for navigating a low-rate environment, integrating alternative asset class mutual funds, tactical versus strategic asset allocation, and retirement investing strategies. Learn more at www.FPAAAnnualConference.org.

According to a February 2011 report from Tiburon Strategic Advisors, no individual trend across the various financial adviser channels is as profound as the shift away from commission brokerage toward the eight types of fee-account programs: fee-based brokerage accounts, broker wrap accounts, mutual fund wrap accounts, annuity wrap accounts, ETF wrap accounts, multiple-style portfolios, separately managed accounts, and unified managed accounts.

And as actively managed ETFs jockey for attention, advisers who prefer the active management style found in some mutual funds may welcome active ETFs into the mix. (For more on actively managed ETFs, see “ETF Trends: Actively Managed Funds Gaining Ground” on page 32 and “What You Need to Know About Active ETFs” on page 34.)

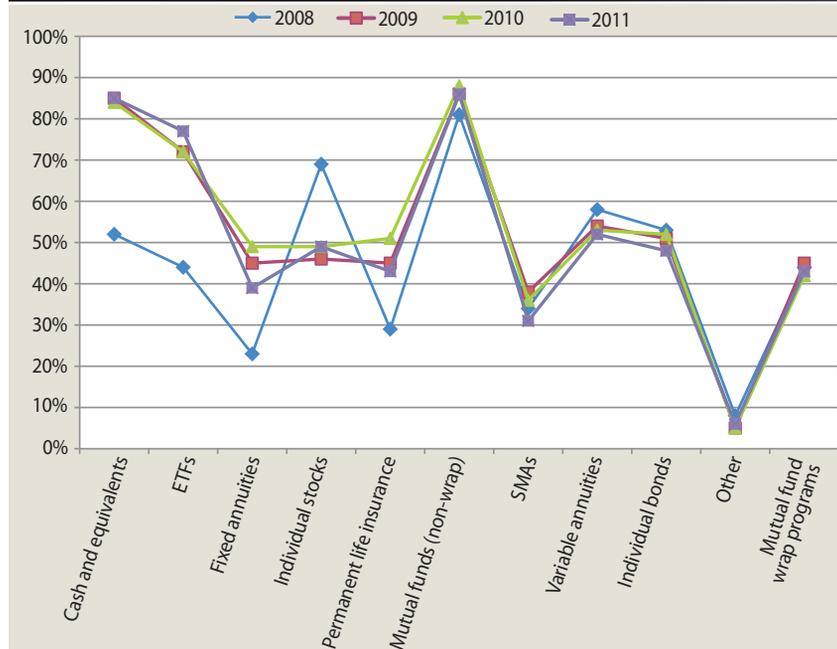
REITs and Alternative Investments Show Impressive Growth

For many advisers, adding real estate to a client’s portfolio—whether through individual REITs, REITs held within mutual funds and ETFs, or via alternative investments—is a way to diversify, generate income through dividends, and capture gains not found recently in equity markets.

FPA’s 2011 *Trends in Investing* study found that more than one-third (36 percent) of advisers currently use or recommend individual REITs—those held outside a mutual fund or ETF. And 36 percent of those currently using individual REITs plan to increase their use of those products over the next 12 months (57 percent plan to maintain their current use and 7 percent plan to decrease their use).

The *Trends* study also found that 22 percent of advisers currently use or recommend individual alternative investments (specifically those bought directly, not included in other investment vehicles such as mutual funds or ETFs).

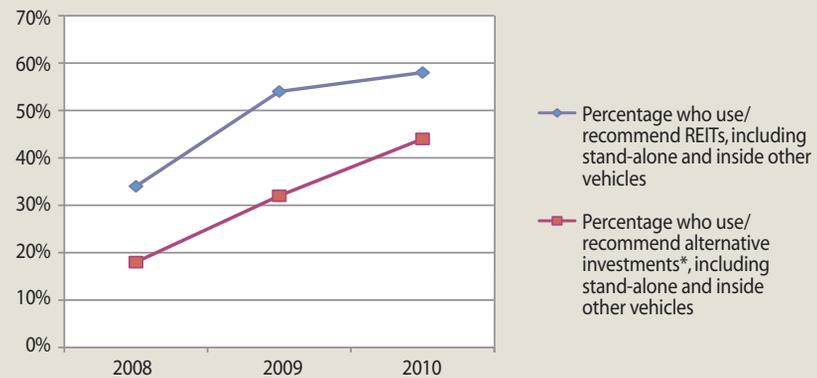
Figure 1: Investment Vehicles Advisers Currently Use/Recommend



* REITs and alternative investments are not included here because comparable 2011 data is not available. See Figure 2.

Source: FPA’s *Trends in Investing* studies, 2008–2011

Figure 2: REIT and Alternative Investment Usage, 2008–2010



* Defined as hedge funds, private equity, options, commodities, currencies, and structured products.

Source: FPA’s *Trends in Investing* studies, 2008–2011

Comparable data for 2011 is not available because the 2011 study gauged the use of individual REITs and alternative investments (those held outside mutual funds and ETFs). In 2011, 36 percent of advisers use/recommend individual REITs; 22 percent use/recommend individual alternative investments.

And among the advisers using alternative investments, 63 percent are using international or global real estate funds.

According to the National Association of Real Estate Investment Trusts (NAREIT), U.S. REITs outperformed

the broader equity markets in 2010 and continued to do so in the first quarter of 2011. The FTSE NAREIT All Equity REITs Index, a free float adjusted market

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though they have not sold any of their own shares. The full brunt of this was felt by mutual fund investors in late 2008 when they not only experienced falling portfolio values but also ended up paying capital gains taxes resulting from large redemptions. In active ETFs, the fund's shares trade on the secondary market and transactions are done through a market maker for the fund. If market makers need to create or redeem more shares, they can do so through an "in-kind" creation/redemption process unique to ETFs. This means that when redemptions occur, the portfolio manager does not have to sell securities and can instead transfer them "in-kind" to the market maker, thereby avoiding any realized capital gains. Hence, the active ETF structure ends up being more tax efficient compared to active mutual funds because investors only incur capital gains tax when they sell their own shares.

Lower Costs. The average expense for an active mutual fund in the United States is 1.21 percent, according to Strategic Insight, while the average expense ratio for existing active ETFs is 0.73 percent, according to ActiveETFs | InFocus. Investors and advisers know how important cost differentials can be to overall portfolio performance over the long run. This difference alone can result in huge costs savings when compounded over the years.

The Drawbacks

Of course, no product is perfect.

Short Track Records. As with any actively managed product, the portfolio manager's performance track record is of paramount importance in helping investors and planners gain comfort with the fund. Active ETFs still have relatively short track records, with the oldest active ETFs being fewer than three years old. Active funds typically start receiving star ratings from Morningstar once they have a three-year track

record. As a result, some planners may not be comfortable with these funds yet. To alleviate this concern, issuers often disclose past performance records in the fund prospectus from other funds managed by the investment manager that had similar investment mandates.

Too Much Transparency? Another feature of active ETFs that has raised some concern is their high level of transparency. Not all market participants have welcomed the amount of transparency active ETFs are required to provide. Most concerned are the portfolio managers themselves, who feel that by disclosing all their holdings every day, they may be opening themselves up to potential front-runners as well as giving away their intellectual capital and alpha-generating strategies. There is considerable discussion on this topic among the issuers, regulators, and market experts, and the eventual conclusion could determine how quickly or slowly the number of active ETFs grows.

The Future

ETFs should no longer be synonymous with a passive management strategy because ETFs now provide investors access to both passively managed and actively managed portfolios. There is undisputed interest from fund managers in active ETFs, but the eventual success of this new kid on the block will really be determined by how well investors and the advisers who serve them warm up to this innovation.



Shishir Nigam is the founder of ActiveETFs | InFocus (www.etfshub.com), the first website dedicated to focused coverage and in-depth analysis of actively managed ETFs.

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capitalization weighted index that includes all tax-qualified REITs listed on the NYSE, AMEX, and NASDAQ, had a total return of 27.95 percent for 2010, compared with the 2010 returns of equity markets of 26.85 percent for the Russell 2000 Index, 16.91 percent for the NASDAQ Composite, 15.06 percent for the S&P 500, and 11.02 percent for the Dow Jones Industrial Average.

For Q1 2011, the total return of the FTSE NAREIT All Equity REITs Index was up 7.5 percent compared to 5.9 percent for the S&P 500.

From 2008 through 2010, both REITs and alternative investments (whether held outside mutual funds and ETFs or not) demonstrated consistent growth in adviser usage according to previous FPA *Trends in Investing* study data (see Figure 2 on page 31).

Economic Outlook: Bullish

Although advisers are not willing to return to their pre-crash investing philosophies of more risk/more potential return, they are regaining confidence in the economy. Sixty-eight percent of 2011 respondents are bullish on the short-term (six months) economic outlook, 58 percent are bullish on the next two years, and 52 percent have an optimistic outlook for the next five years. We're looking forward to seeing how their outlook may affect their investment practices in the year ahead.



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Endnote

1. Statistically valid at a 95 percent confidence level with a 3 percent margin of error, and is representative of the FPA membership.